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No. 95-323

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. In this case, the court of appeals applied judge-made "principles of equitable subordination" to nullify the determination of Congress that postpetition tax penalties should be given "[f]irst" priority in the distribution of the assets of the debtor's estate (11 U.S.C. 507(a)(1)). The court predicated its decision on the view that payment of the tax penalty claim on a first priority basis would be "unfair" to creditors who had extended value to the debtor because it would reduce the assets available for distribution to them (Pet. App. 19a). By allowing its views of what is "fair"

or "unfair" to override the express congressional determination as to the priority to be afforded to these competing claims, the court of appeals violated the fundamental principle that a bankruptcy court's equitable powers "must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)). The Sixth Circuit's decision also conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule." *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The court further compounded its error by ignoring the decisions of this Court that hold that claims for postpetition penalties are to be paid from the assets of the estate in order to ensure compliance with the laws that the penalties are designed to enforce. See *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[1]

2. Respondent errs in contending (Br. in Opp. 11) that the decision in this case will not result in the nonpayment of postpetition tax penalty claims in bankruptcy cases. The court of appeals subordinated the government's claim precisely *because* the estate lacked sufficient assets to satisfy the claims of all creditors (Pet. App. 19a). It is obvious that a similar deficiency in assets exists in virtually all bankruptcy cases. Moreover, in the rare case in which a bankruptcy estate has sufficient assets to satisfy all

[1] Respondent does not dispute that the court of appeals erred in stating (Pet. App. 12a-13a) that all penalty claims were disallowed under the former Bankruptcy Act.

claims, there would be no need to invoke the doctrine of equitable subordination—for all claims would then be paid.

The priority scheme of the Bankruptcy Code serves a purpose only when the assets of the bankruptcy estate are not sufficient to satisfy all claims. The approach adopted by the court of appeals in this case deviates from the priority scheme that Congress enacted by nullifying the express award of first priority to postpetition tax penalties under Section 507(a)(1) of the Bankruptcy Code.[2]

3. Respondent errs in contending (Br. in Opp. 8-9) that the "plain language" of Section 726 supports the decision of the court of appeals. Section 726 merely provides that the priorities Congress established in the Bankruptcy Code apply in Chapter 7 cases "[e]xcept as provided in section 510" (11 U.S.C. 726(a)). Section 726 does not provide any guidance on the issue that is critical to this case: which is *how* the

[2] Respondent argues (Br. in Opp. 11 n.7) that equitable subordination is appropriate to punish the IRS for failure to monitor the estate's compliance with the tax laws. That contention is in error for several reasons. First, the statutory grant of first priority is not contingent upon IRS monitoring of the debtor. Second, as this Court recognized in *Nicholas* v. *United States*, 384 U.S. at 694, the grant of first priority is made precisely to ensure that trustees and debtors-in-possession comply with the tax laws. To argue, as respondent does, that penalty claims should not be paid because the debtor-in-possession did not comply with its obligations turns the statute on its head. Moreover, it is unrealistic to suggest that the IRS is in a position to monitor the internal practices of thousands of bankruptcy estates. Ours is a self-reporting system of taxation, which relies on penalties to assure compliance.

"principles of equitable subordination" codified in Section 510(c) are to be applied.[3]

The decisions of this Court and of other courts of appeals establish that "principles of equitable subordination" require the presence of creditor misconduct. See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948) ("It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong."); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941); *Benjamin* v. *Diamond*, 563 F.2d 692, 700 (5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir.), cert. denied, 314 U.S. 640 (1941); *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787. Moreover, as the petition notes (Pet. 17-19), in codifying these preexisting "principles of equitable subordination" in Section 510(c) of the Bankruptcy Code, Congress considered and rejected a provision that would have granted bankruptcy courts

[3] Respondent errs in asserting (Br. in Opp. 7-8) that the issue in this case is whether equitable subordination applies to priority claims. We do not dispute that priority claims in Chapter 7 cases *may* be subordinated. The question presented by this case involves the *circumstances* under which subordination may be accomplished under "principles of equitable subordination." In our view, those circumstances require creditor misconduct; any subordination based simply upon *the nature of the claim itself* necessarily undertakes to reweigh the competing equities that Congress itself balanced in formulating the statutory priority scheme.

authority to subordinate claims on the broader grounds asserted by the court of appeals in this case.

4. Respondent does not cite or discuss the decisions of the courts of appeals under the former Bankruptcy Act that established the "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code. See, *e.g.*, *In re Columbia Ribbon Co.*, 117 F.2d at 1002; *United States* v. *Killoren*, 119 F.2d at 366; *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787. Moreover, respondent does not dispute that the decision of the court of appeals in the present case conflicts with those preexisting decisions. And, except for the fact that Congress codified the preexisting "principles of equitable subordination" in Section 510(c) of the Code, respondent offers no basis for distinguishing those decisions from the conflicting decision in the present case. In sum, respondent's contention that a conflict does not exist rests solely upon the untenable proposition that Congress changed the preexisting "principles of equitable subordination" under the guise of codifying them.

5. Contrary to respondent's contention (Br. in Opp. 13-14), the decision in the present case has exceptional administrative importance. Trustees and debtors-in-possession often incur tax penalties during the administration of a bankruptcy estate. In *Nicholas* v. *United States*, 384 U.S. at 699, this Court emphasized the importance of requiring payment of such penalties on a first priority basis, to ensure that debtors and trustees abide by the same rules of law that apply to other businesses. As the petition notes (Pet. 22-23), the decision in this case has recurring importance not only for enforcement of federal, state and local tax laws; it also threatens to undermine

enforcement of a broad variety of governmental regulations, such as health and safety rules that are designed to protect workers and the public at large.

Moreover, as one commentator has noted, by unhinging the doctrine of equitable subordination from its traditional framework, the rationale applied by the court of appeals in this case affects not only governmental claims; it has also sent a "chill" through the financial community by threatening to "eclipse the structure of bankruptcy prioritization." Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993). By ignoring and nullifying the priorities that Congress established, the reasoning applied by the court of appeals in this case poses a serious threat to the integrity of the statutory scheme that Congress enacted.

6. As noted in the petition (Pet. 10 n.1), we suggest that this case be set for argument together with *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, No. 95-325, in the event that certiorari is granted in both cases. The second question presented in the *CF&I* case is whether a prepetition excise tax claim under Section 4971(a) of the Internal Revenue Code, 26 U.S.C. 4971(a), may be equitably subordinated to general unsecured claims in the absence of creditor misconduct. Although respondent suggests (Br. in Opp. 15) that the *CF&I* case is distinguishable, the controlling question presented in both cases is identical: whether Section 510(c) of the Bankruptcy Code authorizes equitable subordination of claims in the absence of creditor misconduct. The Tenth Circuit recognized the closeness of these two cases by

relying on the Sixth Circuit's decision in this case in its opinion in *CF&I*. See 53 F.3d 1155, 1158 (1995).

* * * * *

For the reasons set forth above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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Solicitor General

NOVEMBER 1995